FRBSF Weekly Letter

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# Must the Dollar Fall?

The recent strength of the dollar has again raised doubts about the outlook for the U.S. balance-of-payments deficit and the future value of the dollar. Many are concerned that the present and prospective U.S. payment deficits are unsustainable in the long run. To reduce the trade deficit to a "sustainable" level, they argue, either major industrial countries will have to make drastic adjustments in their macroeconomic policies or the dollar will have to fall sharply.

Some also worry that as the dollar declines, U.S. interest rates will have to rise in order to induce foreigners to keep holding and accumulating dollar assets. Given the pivotal role of interest rates in investment decisions, a sharp fall of the dollar could trigger another stock market crash and plunge the economy into recession, they fear.

This *Letter* disputes the basis for such pessimism. Those who claim that the dollar must fall fail to take into account the dollar's unique role in world finance. Given the growing demand for dollar assets, there is no reason to assume the dollar must fall.

But to dispute the claim that the dollar *must* fall is not to assert that the dollar *will not* fall. The former is a question of logic, and the latter involves a prediction. Nonetheless, predictions based on faulty logic are not reliable, and business and government policy decisions based on such predictions could be in serious error.

**U.S. payment deficits**

Dollar exchange rates are determined by the demand for and the supply of dollar assets. The dollar rises when foreign demand for dollar assets exceeds the supply of dollar assets; conversely, it falls when the supply of dollar assets exceeds foreigners' demand.

The supply of dollar assets is closely related to our trade with foreigners. When we buy more goods and services from foreigners than we sell to them, we as a nation offer in payment dollar assets in the form of U.S. bank drafts, corporate stocks and bonds, government securities, industrial and commercial properties, or other kinds of financial claims on the U.S. economy. When we run a trade deficit year after year, the stock of dollar assets held by foreigners rises steadily.

The U.S. payment balance deteriorated sharply in the 1980s. Compared to an annual average deficit of only \$0.4 billion in the 1970s and an average surplus of \$4 billion a year in 1980 and 1981, it worsened sharply in 1983 and reached \$154 billion by 1987. After three years of steep dollar depreciation, the payment deficit finally improved to a seasonally adjusted annual rate of \$140 billion in the first half of 1988. Then the dollar rose during the summer, dampening hopes of further balance of payments improvements. In fact, even before the dollar's recent rise, most forecasts, which assume that the dollar will remain at the level attained at the end of 1987, showed only temporary improvement in the payment balance in 1988 and renewed deterioration in 1989 and beyond. The Data Resources, Inc. (DRI) model, for instance, predicted early this year a U.S. payment deficit of \$175 billion in 1990 and of \$400 billion by 1995.

The large payment deficits of the 1980s have meant that foreigners have accumulated dollar assets at an exceedingly rapid rate. Foreign holdings of financial assets in the United States more than tripled from \$500 billion at the end of 1980 to \$1,540 billion at the end of 1987. Roughly one-half of the more than \$1 trillion increase in U.S. liabilities to foreigners was offset by U.S. acquisitions of foreign assets. The other half, however, is associated with the cumulative U.S. payment deficits that arose during this period.

A common fear has been that this rate of dollar asset accumulation cannot be sustained in the long run; sooner or later, foreigners' desire for dollar assets will wane. This means that the U.S. payment deficit must be reduced from its present level, either through significant changes in major industrial countries' macroeconomic policies or through a precipitous decline in the value of the dollar.

**An anchor for the dollar?**

This line of thinking has led to the view that the long-run value of the dollar—absent macroeconomic policy changes—depends on foreigners' willingness to accumulate dollar assets in the long run. The short-run value of the dollar can be supported by providing attractive interest rate differentials, official exchange market interventions, or even official pronouncements of intentions to insure exchange rate stability. But, according to this view, eventually the dollar must sink to its long-run sustainable level.

In search of this long-run anchor for the dollar, three alternative approaches have been suggested. The first may be called an *absolute limit* approach. It is based on the idea that ultimately foreigners will be so satiated with dollar assets that they will stop accumulating such assets altogether. At that point, the U.S. payment deficit must disappear. Hence, the long-run sustainable value of the dollar, according to this view, is one that will in time reduce the U.S. payment deficit to zero.

The second may be called a *relative limit* approach. It acknowledges that as world wealth grows, foreigners will continue to add to their dollar asset holdings. However, foreigners will not hold more than a proportion of their wealth in dollar assets. That proportion, coupled with the growth in world wealth, establishes the limit on the U.S.' ability to finance its payment deficits. Assuming that world wealth grows at the world real interest rate, simple algebra suggests that except for interest payments on the outstanding debt to foreigners, the U.S. payment deficit must be reduced to zero.

The third approach postulates an *ability-to-pay* test. Clearly, no country, not even the U.S., can pay more than a fraction of its income to service its debt. Proponents of this approach argue that if the current differential between U.S. and foreign interest rates implies an expected future rate of dollar depreciation too slow to bring about significant reductions in future U.S. payment deficits, then the U.S. interest payment on its foreign debt will continue to rise rapidly. Given reasonable assumptions about U.S. income growth, this could imply an ever-rising U.S. debt service-to-income ratio—an obviously unrealistic expectation. According to this view, then, the dollar must decline faster than markets currently expect.

**Will-o'-the-wisp**

Despite their intuitive appeal, these approaches are fundamentally faulty. All three assume persistent irrationality in the foreign exchange market: if only the market were cognizant of the long-run unsustainability of the U.S. payment deficit, the dollar would fall quickly and sharply. Admittedly, the stock market crash last October has shaken confidence in market rationality. But there is no theoretical basis nor empirical evidence to suggest that financial markets in general and the foreign exchange market in particular are persistently irrational.

In addition to this general problem, each approach has its own flaws. The absolute limit approach does not recognize the unique role of dollar assets in world finance. Because the dollar is universally accepted as a means of international payment, dollar assets serve as an international store of value to an extent unmatched by any other asset. Moreover, the breadth, depth, and resilience of U.S. financial markets provide dollar assets a degree of liquidity not available with other assets. There always will be a large and growing demand for dollar assets as world wealth expands.

Although the relative limit approach does recognize a growing demand for dollar assets, it fails to take into account the accelerating international integration of financial markets. Communications technology has made information instantly accessible to investors in major cities around the world. Governments have removed restrictions on capital flows in one country after another. Increasingly, foreign investors are diversifying their assets internationally, primarily by acquiring dollar assets. Until this process of international financial integration is completed and financial markets are fully integrated worldwide, the ratio of dollar assets to total world wealth will continue to rise. Admittedly, in the long run, this ratio will not rise without limit, but for most business and government policy decisions, it is not the long run, but the medium run, that counts.

Finally, the ability-to-pay approach relies solely on adjustments in exchange rates to reduce payment imbalances and ignores all other possible market adjustments, such as changes in income, prices, interest rates, consumer preferences, and/or business investment strategies. Such an approach depends on current conditions to stay unchanged indefinitely and therefore, is not likely to be a reliable forecast. It is this type of analysis that led theorists in the early 19th century to predict perpetual world poverty and in the mid-1970s to forecast world hunger and exhaustion of world petroleum and other natural resources. Fortunately, the market won, and the theorists lost.

In short, the view that the dollar must fall if the U.S. payment deficit continues to rise is based on a shaky foundation. It ignores the rising world demand for dollar assets associated with expanding world wealth and increasing integration of world financial markets. So long as the U.S. continues to manage its economy with prudence by preventing runaway inflation, reducing budget deficits, and refraining from imposing foreign trade and investment restrictions, the U.S. may not face in the medium run any effective constraints on the external financing of its payment deficits.

**Policy implications**

The presence of a large world demand for dollar assets means a powerful market mechanism at work to finance U.S. payment deficits, comparable to that which insures the smooth functioning of inter-regional payment flows and adjustments within a country. A relatively small rise in U.S. interest rates in response to strong growth in domestic demand may be sufficient to ensure external financing of the resultant increase in the U.S. payment deficit. As world financial markets become more integrated, the responsiveness of international capital flows to changes in international interest-rate differentials will increase over time, making it even easier for the U.S. to finance its external deficits without drastic adjustments in its macroeconomic policies.

Whether the demand for dollar assets will indeed be large enough to meet the supply of dollar assets is an empirical question that the foregoing analysis cannot answer. However, the recent strength of the dollar suggests continued strong demand. Given the rate of growth in world wealth and the accelerating pace of financial market integration, it is quite likely that this demand will grow rapidly enough to support the expected persistent U.S. payment deficit.

This judgment implies that in the medium run the persistent U.S. payment deficit is not the sword of Damocles hanging over the U.S. economy, as is generally thought, but a sword supported by a large cushion of world asset demand. Consequently, the U.S. monetary authorities should be able to concentrate on restraining domestic inflation, free from the gnawing fear that monetary restraint now might precipitate a "free fall" of the dollar, soaring U.S. interest rates, another stock market crash, and a plunge into recession later.

In the short run, monetary restraint would cause the dollar to rise and the U.S. payment deficit to worsen. However, monetary restraint also would reduce domestic spending and lessen domestic inflationary pressures, leading to an improvement in the U.S. payment balance. The net outcome of these two influences may be further deterioration in the U.S. payment balance, but the magnitude of the net deterioration is not likely to be significant compared to the growing world demand for dollar assets.

The bottom-line of all this is that there is no reason to think that the dollar must fall in the face of continued large and probably rising U.S. payment deficits. Moreover, given the high sensitivity of this demand to relative asset returns, the monetary authorities of major industrial countries are in a strong position to maintain dollar stability through coordination of their policies. However, exchange rate stability combined with unchanged fiscal policies in the United States and abroad would mean indefinite world financing of U.S. payment deficits and continued growth of U.S. debt to foreigners. Whether this situation is in the long-run interest of both the United States and the rest of the world is a question policymakers must answer.

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